

PERSONAL INCOME TAX

- Statutory Provision

Title 30, Delaware Code, Chapter 11.

- Collection/Administrative Agency

The Department of Finance, Division of Revenue, administers this tax.

- General Liability

Resident

Every resident of Delaware must file a personal income tax return whenever such resident:

- (a) Is required to file a federal tax return; or
- (b) Has adjusted gross income (after modifications) that exceeds the maximum filing thresholds. The maximum filing thresholds for each filing status are listed below:

AGE/STATUS	FILING SINGLE	MARRIED FILING A JOINT RETURN (1)	MARRIED FILING SEPARATE	FILING AS A DEPENDENT ON ANOTHER PERSON'S RETURN
Under 60	\$9,400	\$15,450	\$9,400	\$5,250
60 to 64	\$12,200	\$17,950	\$12,200	\$5,250
65 and over OR Blind	\$14,700	\$20,450	\$14,700	\$7,750
65 and over AND Blind	\$17,200	\$22,950	\$17,200	\$10,250

- (1) This dollar amount represents a taxpayer's individual Adjusted Gross Income, NOT a total combined with anyone else.

Every resident must report all income earned during the taxable year to Delaware, regardless of the source.

Nonresident

Every nonresident must file a tax return to report all income earned within the state. This includes only income attributable to employment or personal services performed in Delaware, or to the ownership or disposition of any interest in real or tangible personal property in Delaware (i.e., wages, business income, capital, rents and royalties, partnerships, farm income and any other income derived from a Delaware source). Interest, dividends and pensions, even if attributable to Delaware employment, are excluded.

Nonresidents calculate their liabilities as if they were residents except that nonresidents' final liabilities are prorated according to their ratio of Delaware source income to total income.

Part-Year Resident

Part-year residents have the option of filing as a resident or a nonresident. By filing as a nonresident, final liability is reduced because it is prorated according to the taxpayer's ratio of Delaware source income to total income. Filing a resident return allows the taxpayer to make use of certain tax credits, such as the child care credit, that are not available to nonresidents. If large enough, these tax credits can produce a final liability that is lower than that which may be obtained by filing as a nonresident.

▪ Tax Rates

For Tax Years 2014 and after, taxable income is assessed at the following rates:

If Taxable Income is Greater Than:	But Less Than:	Tax Liability is Calculated As:	Plus:	On Taxable Income Over:
\$0	\$2,000	\$0.00	0.00%	\$0
\$2,000	\$5,000	\$0.00	2.20%	\$2,000
\$5,000	\$10,000	\$66.00	3.90%	\$5,000
\$10,000	\$20,000	\$261.50	4.80%	\$10,000
\$20,000	\$25,000	\$741.50	5.20%	\$20,000
\$25,000	\$60,000	\$1,001.00	5.55%	\$25,000
\$60,000		\$2,943.50	6.60%	\$60,000

▪ Tax Receipts, net of refunds (millions of dollars)

<u>Fiscal Year</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
<u>Total (\$)</u>	781.2	882.5	1,015.4	1,008.3	1,006.9	910.7	853.1	997.2	1,041.9	1,139.8

▪ Tax Preferences

The following items have been identified as personal income tax preferences within the Delaware Code:

1.01 Low-Income Elderly Exclusion

1. Statutory Provision

Title 30, Delaware Code, Chapter 11, §1106(b)(2).

2. Description

The law provides for exclusions from gross income to persons who meet certain qualifications. If a taxpayer is single, or married and filing separately, the law allows an exclusion of \$2,000 to any person:

- (a) Who is totally and permanently disabled, or who is 60 years of age or older;
- (a) Whose earned income for the year is less than \$2,500; and,
- (b) Whose Delaware adjusted gross income (before this deduction) does not exceed \$10,000.

A husband and wife filing a joint return are entitled to an exclusion of \$4,000 if the following conditions are met:

- (a) Each is at least 60 years of age, or totally and permanently disabled;
- (b) Their total earned income in the taxable year is less than \$5,000; and
- (c) Their Delaware adjusted gross income (without reduction of this exclusion) does not exceed \$20,000.

3. Estimated Revenue Loss

FY 13: Negligible¹

FY 14: Negligible

¹ Defined as less than \$10,000.

4. Assessment

The purpose of this provision is to allow elderly or disabled taxpayers with low income to exclude a portion of their income from taxes. Because certain forms of income are not included in this means test, some higher-income elderly taxpayers may qualify for this preference. Conversely, elderly taxpayers who rely primarily on wage income may not qualify for this exclusion even though they otherwise meet the definition of "low-income."

5. Inadvertent Effects

This provision suffers from a number of defects, which at the time of its original enactment appear to have been overlooked. As the size and scope of other tax preferences expanded, these defects became more prominent.

The eligibility means test is poorly designed, resulting in an application of tax relief that follows no rational pattern. Though ostensibly targeted to help "low-income" elderly taxpayers, in practice, this provision was nearly as likely to help middle- and high-income taxpayers as it was to help the poor. For example, the fact that the income of a taxpayer's spouse is not taken into consideration in determining eligibility means that well-to-do couples may enjoy a "low-income" tax preference simply because their income is unequally distributed between spouses. Some low-income elderly taxpayers were denied relief (elderly wage earners, for example) simply because the composition of their income did not conform to the statute's requirements. Finally, the deduction was "all or nothing." If taxpayers meet the means test, the full deduction is awarded. If taxpayers exceeded the means test amount by one penny, they received nothing.

For taxpayers age 60 and over, events have rendered this tax preference practically useless. Other elderly tax preferences have expanded to such an extent that, beginning in tax year 2000, all taxpayers meeting this provision's eligibility requirement and using the standard deduction already have no tax liability.

Taxpayers who choose to itemize their deductions may still benefit from this provision, provided their itemized deductions are less than the standard deduction amount. Low-income taxpayers who would choose to do so are rare and are most likely the spouse of a high-income taxpayer who makes use of most of the couple's itemized deductions. Because this provision's intended beneficiaries are age 60 and over and already have no tax liability, policymakers should seriously consider its elimination or limit its application to disabled taxpayers.

Modifying the provision's means test to be more inclusive would merely result in the extension of tax relief to middle- and upper-income elderly taxpayers. If policymakers desire such a result, it could be more efficiently achieved through simpler and more targeted means.

1.02 Exclusion of Pension and Eligible Retirement Income

1. Statutory Provision

Title 30, Delaware Code, Chapter 11, §1106(b)(3).

2. Description

Certain amounts of income received as pensions from employers or meeting the definition of "eligible retirement income" are excludable from Delaware taxable income. This exclusion is limited to \$12,500 a year for taxpayers 60 years and older.

As defined in §1106(b)(3)b.2(B) of Title 30, eligible retirement income includes:

- Distributions from qualified retirement plans defined under §4974 of the Internal Revenue Code (IRC);
- Distributions from cash or deferred arrangements described in §401(k) of the IRC;
- Distributions from government deferred compensation plans described in §457 of the IRC;
- Dividends;
- Capital Gains;
- Interest; and,
- Net Rental Income

Taxpayers under 60 years of age may exclude up to \$2,000 of pension income per year. These taxpayers may not exclude eligible retirement income.

3. Estimated Revenue Loss

FY 13: \$49.8 million

FY 14: \$51.9 million

4. Assessment

Unlike the low-income elderly exclusion, the pension exclusion is not means-tested. Any taxpayer with pension or eligible retirement income is entitled to claim this tax preference, regardless of his or her ability-to-pay. The purpose of this provision is to provide a tax reduction to recipients of pension or eligible retirement income; it clearly serves only the intended group.

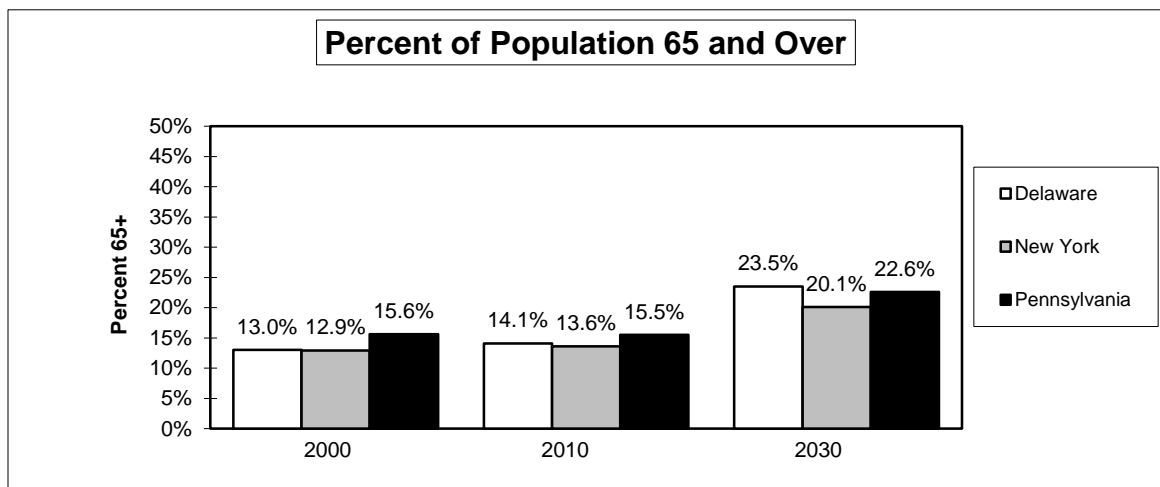
5. Inadvertent Effects

Delaware's progressive income tax rate structure implies that any non-means-tested, lump-sum exclusion from taxable income – such as the pension and eligible retirement income exclusion – provides a larger tax benefit to higher-income taxpayers than to lower-income taxpayers. For example, “Pensioner A” has \$112,500 in income, \$100,000 in taxable income once the exclusion is taken. This exclusion will provide Pensioner A with an \$825 reduction in tax liability in tax year 2014 ($\$12,500 \times 6.60\%$). “Pensioner B” has \$20,000 in income, \$7,500 in taxable income once the exclusion is taken. Because Pensioner B is subject to a lower marginal tax rate, the same \$12,500 exclusion will reduce Pensioner B's tax liability by only \$578 in tax year 2014 ($\$10,000 \times .048 + \$2,500 \times .039$), significantly less benefit than for the high-income Pensioner A.

With respect to other states in the region, Delaware's maximum pension exclusion of \$12,500 may appear to be relatively small. New York allows a maximum pension exclusion of \$20,000 and complete exclusion for federal, state, and military pensions.² Pennsylvania provides complete exclusion for public and private pension benefits.³ Some observers argue that elderly taxpayers will migrate to states such as New York and Pennsylvania in order to benefit from their favorable tax treatment of retirement income. There is some anecdotal evidence to support this claim. However, demographic data suggest that it is not a major phenomenon. The U.S. Bureau of the Census estimates that the percent of Pennsylvania and New York residents over 65 will rise from 15.6% and 12.9% in 2000 to 22.6% and 20.1% by 2030, respectively. The percent of Delawareans over 65 is expected to increase similarly during the same time period: from 13.0% to 23.5%. (See chart below.)

² New York Statutes - Article 22, §612(c)(3-a)

³ Pennsylvania Statutes - Article III, §7301(d)(iii)



Source: U.S. Census Bureau. www.census.gov/population/projections/PressTab3.xls

This suggests that factors other than the tax treatment of retirement income have a more profound impact of the location decisions of retirees. Another real possibility is that the combined impact of Delaware's many retirement tax preferences are, in fact, very competitive relative to other states in the region. Delaware has distinct advantages over neighboring states with respect to property and sales taxes. For the majority of retirees, Delaware's overall tax burden is lower than that of surrounding states.

Proponents of tax preferences for the elderly argue that an increased elderly concentration provides an economic stimulus, especially with respect to service markets. Unless tax preferences for the elderly are significant enough to generate a net increase in tax revenues, then the direct revenue losses imply that marginal tax rates have to be higher than they would be without the preferences in order to generate the same revenues. The effect of elderly preferences, therefore, may be to reduce taxes for taxpayers over age 60 at the cost of increasing taxes for wage earners (whose labor supply decisions are most responsive to changes in after tax wages). Proponents also argue that tax relief based on age is justified because these taxpayers have, after a lifetime of tax paying, paid their "fair share" and at some point deserve relief.

Critics of tax preferences based solely on age disagree with these points for several reasons. Due to the growth in benefit payments and longevity after retirement, many government programs for the elderly are paying significantly more to beneficiaries than the recipients ever paid into the system in taxes. Estimates show, for example, that most current Social Security recipients will receive many times more in benefits than they and their employers paid into

the Social Security system. Because elderly services have grown in cost and total quantity, it takes longer for a person to pay a "fair share" than it did 30 years ago. Another concern is that some exclusions may be taken by persons still in the workforce. This pension exclusion, for example, allows workers who begin to draw a pension at age 45 to exclude \$2,000 of income from taxation while other similarly situated taxpayers get no such break.

Finally, preferences that depend only on age or income source are not as closely linked to ability-to-pay as they were at their inception, when persons over age 60 were the poorest segment of society (see discussion below). All elderly preferences, except the low-income exclusion, can be used to reduce liability for even the wealthiest taxpayers as long as they meet the age requirement.

While the extension of eligibility to other sources of retirement income has improved the horizontal equity problems of this preference *among taxpayers over 60*, there are still some equity concerns.⁴ When compared to income or other ability to pay considerations, age is a fairly arbitrary criterion for a tax preference. It could be argued that the horizontal equity problems of this preference between taxpayers over and under 60 years of age have been aggravated by this most recent change. For example, consider two hypothetical taxpayers with \$1,000 in pension income and \$3,500 in other eligible retirement income. "Taxpayer A" is 59 years old, while "Taxpayer B" is 61. Assuming both taxpayers have the same ability to pay, Taxpayer A can only exclude \$1,000 while taxpayer B can exclude \$4,500. Not only is taxpayer A's exclusion capped at \$2,000 in the aggregate, it is limited to traditional pension income. For taxpayers under 60 without pension income, no exclusion is allowed.

As the following table shows, the rate of poverty among the elderly is now lower than the general population. In 1970, 24.6% of those age 65 and over lived under the federal poverty level. By 2012, the proportion had dropped to 9.1%.

⁴ The exclusion of pension income alone resulted in more favorable tax treatment for taxpayers whose income is derived from a pension, rather than other forms of retirement income.

Percent of Population Below Federal Poverty Level 2012

Under 18	21.8%
18-24	20.4%
25-34	15.9%
35-44	12.4%
45-54	10.8%
55-59	10.7%
60-64	10.7%
65+	9.1%
Overall Rate	15.0%

Source: U.S. Census Bureau, Current Population Survey, 2013 Annual Social and Economic Supplement. www.census.gov/hhes/www/cpstables/032013/pov/pov01_100_1.xls

The rate of poverty is significantly lower for the elderly than for children and young adults. As the elderly are statistically no poorer than any other age group in society, a single age test may benefit taxpayers who do not need relief under any legitimate interpretation of ability-to-pay.

Elderly wage earners who must continue to work to make ends meet are ignored by this provision. Because wages are not eligible for the exclusion, the working poor elderly receive no assistance.

While there is certainly a significant proportion of the elderly population with income below federal poverty levels, policymakers might consider whether government support should more properly continue to be based on age rather than on need and/or ability-to-pay.

1.03 Exclusion of Taxable Social Security Benefits

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1106(b)(4).
2. Description
The state of Delaware excludes Social Security and Railroad Retirement Board income from the personal income tax. For purposes of federal income taxation, recipients of these benefits who have modified adjusted gross income from all sources above a "base amount" of \$25,000 (\$32,000 for taxpayers who file jointly) are taxed on a portion of their payments. This taxable portion is the lesser of 50% of the Social Security benefits received, or

50% of a taxpayer's "combined" income over the "base amount." Combined income is 50% of these benefits plus adjusted gross income plus any tax-exempt income or income earned from a foreign country or U.S. possession which is excluded from federal gross income. If a taxpayer's income exceeds \$34,000 (\$44,000 if married, filing jointly), the lesser of 85% of Social Security benefits or 50% of the combined income above the base amount is included in federal adjusted gross income.

(A complete description of the federal tax code provision relating to social security can be found in IRS Publication 915: Social Security and Equivalent Railroad Retirement Benefits.)

3. Estimated Revenue Loss

FY 13: \$40.0 million

FY 14: \$42.0 million

4. Assessment

The purpose of this provision is to provide a tax reduction to Social Security and Railroad Retirement Board benefit recipients. This exclusion benefits its intended beneficiaries.

5. Inadvertent Effects

Like the exclusion for certain forms of pension income (Item 1.02), this provision is not a means-tested tax preference. Higher-income taxpayers are eligible for, and benefit more from, this provision than do lower-income taxpayers. As a result, much of the preceding discussion of the pension exclusion is also valid with respect to this exclusion of federal benefits. Despite the fact that this tax relief is provided to Social Security and Railroad Retirement Board recipients because they are perceived as being in need, taxpayers who do not fit this generally accepted perception of being in need may also receive benefits.

Delaware's exclusion of federally taxable Social Security and Railroad Retirement Board benefits effectively removes a federal means test which is designed to limit the preferential tax treatment of such income to those most in need. Only taxpayers over certain income thresholds are required to include such benefits in federal gross income. By definition, only taxpayers who have income above these relatively high thresholds benefit from the exclusion of federally taxable Social Security or Railroad Retirement Board benefits.

1.04 Exclusion of Benefits Received Through Travelink Program

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1106(b)(6).
2. Description
Individual income taxpayers may exclude from taxable income \$100 per month in benefits received under the state's Travelink traffic mitigation program (to the extent that the taxpayer included these benefits in calculating federal adjusted gross income).
3. Estimated Revenue Loss
FY 13: Negligible
FY 14: Negligible
4. Assessment
This component of the Travelink Program supplements the business tax incentives also available through this program. (See Item 2.07 below.) The fiscal impact of the personal income tax exclusion is dependent upon employer response to these more prominent business tax credits. Participation in the program has traditionally been low.
5. Inadvertent Effects
The Travelink Program's benefits should accrue to those intended: employers and employees that participate in traffic mitigation efforts. However, neither the threat of federal regulation nor these tax credits seem to have encouraged workers to reduce the number of single-occupant trips they make.

Larger phenomena, such as the price of gasoline and the availability of public transportation, exert a greater influence on commuting decisions. Significant participation in the program remains unlikely.

1.05 Additional Standard Deduction for the Blind or Persons Age 65 or Over

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1108(b).

2. Description

Taxpayers who are at least 65 years of age (or blind), and who do not itemize their deductions, are entitled to an additional standard deduction of \$2,500. Non-itemizers who are at least age 65 *and also* blind may claim an additional standard deduction of \$5,000.

3. Estimated Revenue Loss

FY 13: \$3.8 million

FY 14: \$4.0 million

4. Assessment

The purpose of this provision is to provide a tax reduction to persons who are blind and/or at least 65 years old. The provision's benefits reach only those for whom it was intended.

5. Inadvertent Effects

As is the case with the exclusion of pension income (see Item 1.02 above) and the exclusion of taxable Social Security income (see Item 1.03 above), this provision is not means-tested. With respect to this preference's age criterion, many of the same issues that arise with other non-means-tested preferences for the elderly arise here as well. The additional standard deduction benefits many higher-income taxpayers who have no need for tax relief on ability-to-pay grounds but who qualify solely because of their age.

By definition, an additional standard deduction is not available to taxpayers that itemize their deductions. Because taxpayers that take the standard deduction typically have lower incomes, it may be argued that this additional standard deduction primarily benefits lower-income taxpayers. However, many taxpayers in this age group no longer have mortgage interest deductions, making them less likely to itemize even if they are middle or high-income taxpayers.

An additional standard deduction that is available to individuals who are blind but not to individuals with other disabilities may violate horizontal equity. Taxpayers may have disabilities that affect their ability-to-pay similarly or more severely than blindness, but they would not be eligible for this deduction.

1.06 Charitable Mileage Deduction

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1109(a)(2)(a).
2. Description
Federal law permits a person who uses his/her automobile to perform voluntary service for a charitable organization to claim an itemized deduction for a portion of those expenses. Under Delaware law, this additional itemized deduction is calculated by subtracting the permissible federal rate for automobile mileage (currently 14 cents per mile) from the amount state employees may claim for work-related use of their vehicles (40 cents effective July 1, 2006).
3. Estimated Revenue Loss
FY 13: Less than \$50,000
FY 14: Less than \$50,000
4. Assessment
Though small, this preference does provide relief to those individuals who have to drive in order perform voluntary services for charitable organizations. The benefits of this provision go to those intended and do not produce a large fiscal loss. As an itemized deduction, however, the provision does not benefit those taxpayers who use their vehicles for charitable purposes but who take the standard deduction.

Another concern arises from the fact that only one type of charitable activity (driving) is singled out for favorable tax treatment.
5. Inadvertent Effects
None noted.

1.07 Additional Personal Credit for Persons Age 60 and Over

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1110(b)(2).
2. Description
Taxpayers who are age 60 and over are entitled to claim an additional non-refundable personal credit. Married taxpayers who file jointly receive an

additional \$110 credit if only one of the couple is age 60 or older, and an additional \$220 if the both persons meet this age test.

3. Estimated Revenue Loss

FY 13: \$9.6 million

FY 14: \$10.0 million

4. Assessment

The purpose of this provision is to reduce tax liability for persons age 60 and over. Only persons who meet this age test can receive this extra credit, thus ensuring that the provision serves only the intended beneficiaries.

The switch from an extra personal exemption, to an extra non-refundable personal credit for persons over 60 eliminated the regressivity inherent in the additional personal exemption. The value of the tax credit (which reduces tax liability dollar for dollar) is the same for taxpayers in all income ranges.

5. Inadvertent Effects

As discussed above (see items 1.02 and 1.06), age may be an arbitrary condition for grant favorable tax treatment. This preference suffers from the same drawbacks as other non-means-tested tax breaks for the elderly: taxpayers with the same ability-to-pay receive different tax treatment based solely on age, violating horizontal equity.

Moreover, high-income elderly taxpayers receive benefits that are not available to younger taxpayers with substantially less ability to pay, increasing regressivity in the tax code.

1.08 Credit for Expenses Incurred by Active Volunteer Firefighters, Fire Company Auxiliary Members or Members of Volunteer Ambulance or Rescue Service

1. Statutory Provision

Title 30, Delaware Code, Chapter 11, §1113.

2. Description

The provision allows Delaware residents who are active emergency service volunteers to claim a \$400 credit against their income tax otherwise due. In order to qualify for the credit, a person must be:

- (i) an active volunteer firefighter on call to fight fires on a regular basis; and,
- (ii) a voting member of a Delaware volunteer company; or,
- (iii) a voting member of a Delaware fire company auxiliary; or,
- (iv) an active member of a Delaware volunteer ambulance or rescue service.

3. Estimated Revenue Loss

FY 13: \$1.8 million

FY 14: \$1.8 million

4. Assessment

The purpose of this credit is to help defray the costs incurred by emergency service volunteers in performing their duties. This is clearly a worthy goal, but it is worth assessing whether it is most appropriately addressed through the tax code. As an alternative, the state could make additional direct annual grants to volunteer fire companies for volunteers' expenses equal to the estimated revenue loss that this preference creates. This approach would avoid an additional complication of the tax code and would simplify administration as the state could work with a manageable number of fire companies rather than reviewing claims by thousands of volunteer firefighters on their tax returns.

5. Inadvertent Effects

None noted.

1.09 Child Care and Dependent Care Expense Credit

1. Statutory Provision

IRC, §21.

Title 30, Delaware Code, Chapter 11, §1114.

2. Description

This non-refundable credit is equal to 50 percent of the federal child and dependent care credit allowed for a given taxpayer. The federal credit amount is determined by applying a percentage (between 35% and 20% depending on the size of adjusted gross income) to qualifying expenses (a maximum of \$3,000 for one child, or \$6,000 for two or more children). For taxpayers with federal adjusted gross incomes over \$43,000, the maximum credit is 20 percent of qualifying expenses.

Married couples filing joint federal but separate Delaware returns are limited to applying the credit to the tax liability of the spouse with the smaller taxable income. The credit can be taken for payments made to a relative for child care, provided that the relative is not claimed as dependent on the taxpayer's return and is not the taxpayer's child under the age of 19.

3. Estimated Revenue Loss

FY 13: \$5.0 million

FY 14: \$5.1 million

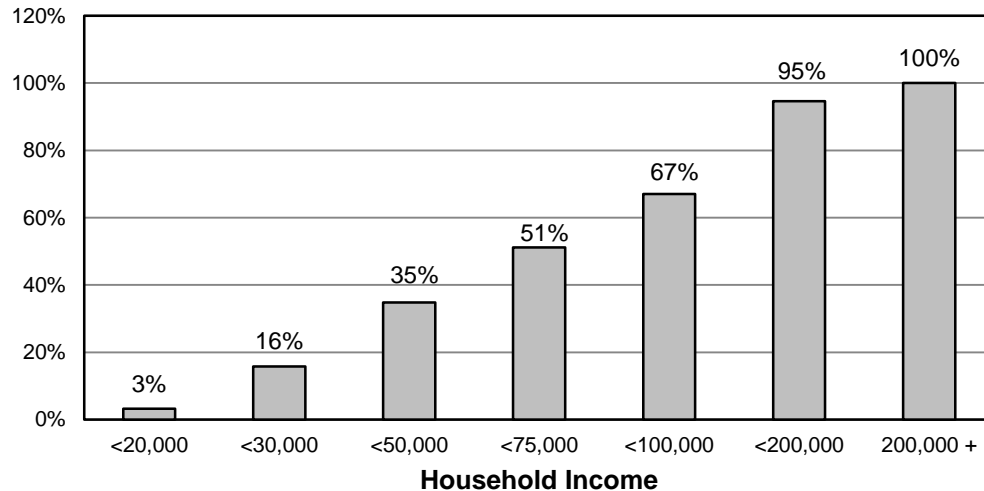
4. Assessment

This credit is intended to encourage the expansion of the state's workforce, particularly for entry-level positions, by removing a major obstacle to employment for many potential workers. A significant number of job seekers are single parents in search of relatively low-wage jobs.⁵ For these individuals, the high cost of child care is not affordable on the potential wages. The credit, therefore, is intended to offset a significant barrier to entry into the labor force. The degree to which an annual tax subsidy – often received in the form of a refund – is likely to make lower wage jobs economically feasible for parents entering the labor market is debatable.

Although this preference is intended to target economically disadvantaged families, a substantial portion of its benefits accrue to families with moderate and more abundant means. In 2011 roughly 33 percent of the child care credits claimed by Delaware families were claimed by families with Delaware Adjusted Gross Incomes of more than \$100,000 (see chart below).

⁵ The IRC also allows the credit to be claimed for other persons (e.g., a spouse or parent) who are physically or mentally unable to take care of themselves and claimed as a dependent on the taxpayer's return.

Who Claims the Delaware Child Credit (2011)



A credit for child care expenses can be viewed as consistent with a definition of taxable income that excludes costs associated with earning income.⁶ As such, some observers may not regard the provision as a tax preference. However, some costs of earning income, such as work apparel and commuting expenses, are not deductible. If child care expenses were to be considered non-preferential as a cost of earning income, then this provision should be structured as a deduction from taxable income and not as a credit.

5. Inadvertent Effects
None noted.

1.10 Tax Credits for Creation of Employment, Qualified Investments in Business Facilities, and Clean Energy Technology Device Manufacturing

1. Statutory Provision
Title 30, Delaware Code, Chapter 11, §1115.
2. Description
The law offers tax credits for any eligible taxpayer who is not subject to the corporate income tax under the same terms as those discussed below for items 2.05, 2.06, and 2.08. Resident shareholders in eligible S Corporations are

⁶ This line of reasoning is used to justify a host of deductions against both personal and corporate income taxes for costs incurred in the earning process (e.g., the federal deduction for home office expenses, the federal deduction for business meals).

entitled to a proportionate share (based on the percentage of ownership in the organization by the taxpayer) of the credits listed. The credits are limited to 50% percent of the tax owed multiplied by the taxpayer's share of distributable income of the S Corporation.

3. Estimated Revenue Loss

FY 13: \$800,000 - \$1,000,000

FY 14: \$800,000 - \$1,000,000

4. Assessment

This provision extends the credits available under the corporate income tax and gross receipts tax to those eligible taxpayers who are subject to the personal income tax, such as S corporation's shareholders. These personal income tax credits raise the same issues as the investment tax credits discussed later in this Report's corporate income tax section. For example, the credits may be too small to generate a significant incentive to increase investments in the intended industries and locations. Many businesses and individuals may be receiving tax reductions for investments and improvements that they would have undertaken anyway in the absence of the credits. For a full discussion of these issues, please refer to Items 2.05 and 2.06 below.

5. Inadvertent Effects

As mentioned above, since its inception, the Blue Collar Jobs Credits has been expanded several times and is sometimes identified as a program in which this incremental approach may have resulted in unanticipated shortcomings. Please refer to Items 2.05, 2.06, and for a full discussion of possible inadvertent effects.

1.11 Military Action Exemption

1. Statutory Provision

Title 30, Delaware Code, Chapter 11, §1171.

2. Description

Income earned by U.S. Armed Forces personnel while on active duty who die from disease or injuries incurred while serving in a combat zone is exempt from the personal income tax. Unpaid outstanding tax liabilities of such individuals are forgiven.

Additionally, income earned by U.S. Armed Forces personnel located outside the United States who die in “terroristic or military actions” is exempt from the personal income tax.

3. Estimated Revenue Loss

FY 13: Negligible

FY 14: Negligible

4. Assessment

This preference reaches its policy objectives in a fiscally effective manner. Even though the recent years have seen U.S. forces deployed in large numbers, the cost of this preference remains low. This is true because:

- (1) Delaware is a small state, and its citizens constitute only a small fraction of the total military compliment;
- (2) Members of the armed forces have discretion in determining their residence. A significant number choose states like Texas and Florida, which do not levy income taxes; and,
- (3) Compared to other wars, such as World War II, Korea, and Vietnam, the number of casualties suffered in recent years has been relatively small.

Barring a major military engagement, war, or terrorist action overseas resulting in a much larger number of casualties, the cost of this preference will remain negligible.

5. Inadvertent Effects

None noted.

1.12 Extension of Filing Deadline for Military Personnel or Support Staff Serving in a Combat Zone

1. Statutory Provision

Title 30, Delaware Code, Chapter 3, §376.

2. Description

Military personnel who serve in a combat zone (pursuant to Section 112 of the IRC) are permitted to file their income tax returns up to 195 days after leaving the combat zone.

3. Estimated Revenue Loss

FY 13: Negligible

FY 14: Negligible

4. Assessment

Delaware's General Assembly implemented this provision in 1991 in response to Operation Desert Storm. Legislators recognized the practical difficulty of requiring military personnel to file a state personal income tax form while actively engaged in an overseas military operation.

This item is the most effective means of achieving its purpose fiscally and benefits those intended. The resulting impacts on final payments and refunds are minor. This provision is included as a tax preference because the filing deadline extension functions as a tax deferral in cases where a payment is due with the final return. While the deferral of final payment may amount to an interest-free loan from the state to the taxpayer, it is likely that many reservists' wage withholding levels were not adjusted to compensate for lower earnings during military service. In these cases, this filing deadline extension may actually result in the deferral of refund checks.

5. Inadvertent Effects

None noted.

1.13 Exemption for Retirement Distributions Used for Education

1. Statutory Provision

Title 30, Delaware Code, Chapter 11, §1106(b)(8).

2. Description

This preference allows an exemption from taxable income for early distributions from qualified retirement and deferred compensation plans, provided that the distribution is used in the same tax year to pay for books, tuition or fees at an institution of higher education. This exemption is available if the distribution is used to pay for costs incurred by the taxpayer receiving the distribution or any of the taxpayer's dependents under the age of 26.

3. Estimated Revenue Loss

FY 13: \$1.25 million – \$1.75 million

FY 14: \$1.25 million – \$1.75 million

4. Assessment

The purpose of this exemption is to provide parents of college age children with an additional alternative for funding their child's education. It assumes that the saving rate among families for their children's college education is insufficient. The provision's marginal impact is difficult to isolate, but it is likely minimal given all the financial considerations that affect college-funding decisions.

For example, consider a joint return filer in the 28.0% federal tax bracket. In the absence of this provision, this taxpayer would face a combined state and local marginal tax rate on early distributions from retirement plans of 34.6% in tax year 2014 (28.0% federal income tax rate + 6.60% state income tax rate). By allowing an exclusion for state tax purposes, the marginal rate facing this hypothetical taxpayer is reduced to 28.0% (a 19.1% reduction – 6.6%/34.6%). The degree to which such a reduction increases the use of retirement funds for higher education costs is uncertain.

5. Inadvertent Effects

Nationally, 49% of taxpayers who made deductible contributions to individual retirement accounts had adjusted gross incomes of \$75,000 or more in 2008, according to IRS data. Low income families are most likely to need assistance with higher education costs, but they are also likely to have less money invested in retirement funds. This provision may benefit high income families disproportionately.

Additionally, to the extent that the provision does encourage the use of retirement funds for higher education costs, the amount available for distribution after retirement is reduced. Because the income from qualified distributions from tax deferred retirement vehicles is included in adjusted gross income, the use of retirement funds for higher education costs could reduce the amount available for retirement and the tax revenues these funds would generate.

1.14 Exemption for Trusts Established as “Designated” or “Qualified” Settlement Funds

1. Statutory Provision

Title 30, Delaware Code, Chapter 11, §1133(d).

2. Description

This provision exempts from Delaware income taxes the earnings of trusts that are recognized as “designated” or “qualified” settlement funds IRC §468B. Generally speaking, these types of settlement funds are established to satisfy claims arising out of tort, breach of contract, injury, death, property damage or violation of the law. *Designated* settlement funds may only be established by courts. *Qualified* settlement funds may be established by any government agency or instrumentality.

IRC §468B(b)(3) exempts “qualified payments” to a designated settlement fund, defined as money or property transferred to a fund pursuant to a court order, from the fund’s gross income. Treasury Regulations Section 1.468B-2 exempts “amounts transferred to the qualified settlement fund...to resolve or satisfy a liability for which the fund was established” from gross income. In the absence of this provision, trust income for state tax purposes would include any income other than transfers to pay claims, such as interest income from fund assets.

3. Estimated Revenue Loss

FY 13: Unknown

FY 14: Unknown

4. Assessment

This preference is intended to further Delaware’s reputation as a leader in the financial services sector. Since these funds are established by agreement between plaintiffs and defendants in civil cases, the prospect of taxation in Delaware would make it very likely that the parties to a suit would seek to establish such a fund outside the state. The Department is not aware of any funds currently existing in Delaware, but the aim of this preference is to encourage their formation here. How successful this preference will be in achieving its intended purpose is unknown.

It is likely that any funds which are located in Delaware due to this exemption would not be located here in the absence of this preference. Therefore, the state would not likely stand to gain additional revenue if it were to eliminate the credit.

5. Inadvertent Effects
None noted.

1.15 Land and Historic Resource Tax Credit

1. Statutory Provision
Title 30, Delaware Code, Chapter 18, §§1801 – 1807.
2. Description
This preference allows an income tax credit for permanent gifts of land or interest in land to public agencies and qualified private non-profit charitable organizations. Lands that qualify must either:
 - (1) meet the criteria for Open Space established by the Delaware Land Protection Act;
 - (2) Consists of natural habitat for the protection of Delaware's unique and rare biological and natural resources; or,
 - (3) Protect Delaware's important historic resources.

The tax credit is based on 40% of the appraised fair market value of the gift. The amount of credit that can be claimed is limited to \$50,000. In any one tax year, the credit claimed cannot exceed the tax due, but unused portions of the \$50,000 credit can be carried forward for up to five (5) consecutive years. The credit became available on January 1, 2000.

3. Estimated Revenue Loss ⁷
FY 13: Negligible
FY 14: Negligible

4. Assessment
The goal of this tax preference is to encourage land conservation and historic preservation by providing an income tax preference for the donation of lands to the state or qualifying conservation organizations.

The state will have limited control over the types of land donated and the location of such land (subject to limitations discussed above) and no control over the timing of such donations. As an alternative, the state could make

⁷ The maximum amount that can be awarded in any one year cannot exceed \$1 million.

outright purchases of properties deemed desirable for conservation. This approach would avoid an additional complication of the tax code and restore some degree of control and predictability to land conservation efforts.

5. Inadvertent Effects

In effect, through the adoption of this preference, the state is attempting to address a perceived market failure: the loss of open space. Like many business development incentives, a common criticism of awarding tax breaks for conservation efforts is that, in many instances, the desired behavior would have occurred in the absence of the tax break. That is, many of the land-owners who choose to participate in this program may have never contemplated developing their land. In such instances, this provision acts as a “bonus” and not as an incentive that actually changes behavior.

Whether the value of preserving open space exceeds the benefits of allowing market forces to determine the lands' "highest and best" use is debatable. If open space preservation efforts are extensive enough they could influence real estate markets by increasing housing prices in certain areas.

1.16 Historic Preservation Credit

1. Statutory Provision

Title 30, Delaware Code, Chapter 18, §§1811 – 1817.

2. Description

Under this provision, a person who wishes to repair or otherwise preserve a historic property may apply to the State Office of Historic Preservation, for a partial credit for qualified expenditures.

To qualify for the credit, an individual must first submit a rehabilitation proposal to the Office of Historic Preservation to ensure that the restoration, when completed, would meet federal and state guidelines. Credits would be granted on a first come-first serve basis, not to exceed \$5 million⁸ in any one fiscal year. Moreover, \$100,000 of the credits awarded in a given fiscal year must be reserved for distribution to qualified resident curators.

Upon project completion, a State Preservation Office must certify that the end product conforms to federal and state requirements. Once certified, the Division of Revenue or the Office of the State Bank Commissioner will

⁸ The annual credit allocation was increased from \$3 million to \$5 million from Fiscal Year 2006 onward.

determine the appropriate value of the tax credit to be issued.

Personal/corporate income or bank franchise tax credits may be valued at:

- 20% (30% in the case of low income housing) of qualified expenditures made in the rehabilitation of any certified historic property eligible for a federal tax credit under §47 of the Internal Revenue Code (income producing properties);
- 30% (40% in the case of low income housing) of qualified expenditures made in the rehabilitation of any certified historic property not eligible for a federal tax credit under IRC §47 (non-income producing properties); or
- 100% of the qualified expenditures made in the rehabilitation of a certified historic property qualifying for credit award as a resident curatorship property regardless of eligibility for a federal tax credit under IRC §47 [26 U.S.C. §47].

Rehabilitative efforts taking the following forms do not qualify for the Historic Preservation Credit:

- 1) The acquisition of real property or interest in real property,
- 2) Additions to existing structures when the square footage of all additions is greater than or equal to 20% of the total square footage of the historic portion of the property,
- 3) Paving or landscaping costs that exceed 10% of the total qualified expenditure,
- 4) Sales and marketing costs, or,
- 5) Expenditures not properly charged to a capital account, or, in the case of owner occupied property, would not be charged to a capital account if the owner were using such property in a trade or business.

3. Estimated Revenue Loss⁹
FY 13: \$200,000 - \$300,000
FY 14: \$200,000 - \$300,000

4. Assessment

The intention of this provision is to encourage private sector participation in maintaining and preserving the state's historic structures. However, since no public purpose is required for participation in this program, it is possible that the benefits enjoyed from this credit could accrue to relatively few and most likely wealthy individuals. Credits could be issued for renovations conducted on privately owned homes located in isolated areas. In these instances, taxpayers subsidizing the historic renovation would be unable to even view that for which their tax dollars have paid. Recent experience, however, has proven that businesses account for the majority of those qualifying to take this credit.

Additionally, it is unlikely that individuals with insufficient means to undertake renovations would be motivated by this tax incentive. As such, it is possible that this credit may act more as preservation subsidy than as a preservation incentive.

Because this preference is administered on a first-come, first-serve basis, it would also be possible for funds, which should have been allocated to the state's most important historic resources to instead, be diverted to other, potentially less worthy, properties. Moreover, this method of allocation may cause equity concerns given that there is no restriction on the amount of tax credit than can be granted to any one taxpayer. Consequently, one taxpayer could receive the entire \$5 million dollar credit allotment in any given year.

5. Inadvertent Effects:

As previously mentioned, aside from the resident curator provision there is nothing preventing one large taxpayer from receiving the remainder of the credits available in any given fiscal year. Such allocation of the credit may actually hinder preservation efforts by causing individuals who would have otherwise begun historic rehabilitation to postpone projects until the credit is once again available. Additionally, equity concerns are a likely consequence of credit monopolization.

⁹ Claims against tax credits may not be taken until approved projects are completed.

1.17 Earned Income Tax Credit

1. Statutory Provision:
Title 30, Delaware Code, Chapter 11 § 1117.
2. Description:
Federal law permits certain low-income individuals with earned income, meeting adjusted gross income thresholds, to take a refundable Earned Income Tax Credit (EITC). Starting with Tax Year 2006, Delaware taxpayers who qualify to take the federal EITC are permitted to take a non-refundable state tax credit equal to 20% of the federal amount.
3. Estimated Revenue Loss
FY 13: \$8.3 million
FY 14: \$8.7 million
4. Assessment:
EITC advocates consider this credit to be an important tool in fighting poverty. Since 1975, the federal Earned Income Tax Credit has worked as an income subsidy which is delivered through the tax code and targets the working poor. As opposed to traditional welfare programs, proponents argue that the EITC encourages socially beneficial behavior by rewarding work.
5. Inadvertent Effects:
Among federal tax preference items, the EITC has one of the higher rates of errors and noncompliance. Because the federal EITC is a refundable credit, the impact of these errors and noncompliance frequently exceed the amount of federal tax otherwise due. Delaware has attempted to limit the state's financial exposure in this respect by issuing only non-refundable credits. Delaware's experience administering its EITC is largely consistent with the federal track record. More than 35% of the returns claiming the EITC contain errors or indications of noncompliance. Among Delaware's personal income tax preference items, the EITC is the largest source of return processing exceptions.

As a consequence, the administration of the EITC, an effective low-income subsidy, appears to come at a somewhat higher cost relative to the cost of other tax preference items.

1.18 Exemption of Out-of-State Resources During Declared Emergencies

1. Statutory Provision
Title 30, Delaware Code, Chapter 31, §§ 3101 – 3105.
2. Description
Delaware does not consider out-of-state property and personnel employed by infrastructure companies during a declared state of emergency to have a legal presence in the state for tax purposes if those assets are employed in emergency related work.
3. Estimated Revenue Loss
FY 13: Negligible
FY 14: Negligible
4. Assessment
This preference may facilitate the response to future disasters by eliminating tax concerns of companies employing out-of-state resources. Firms will not be required to calculate and submit income tax withholdings for out-of-state individuals conducting infrastructure work during a declared emergency period. This may remove a potential barrier to bringing those individuals into the state.

The revenue lost from this preference is likely to be negligible for two reasons. First, the probability of a declared disaster occurring during a fiscal year is small and unpredictable. Second, enforcement would likely be low if Delaware chose to tax this activity.
5. Inadvertent Effects
None noted.